Investment Advisory Committee (IAC) Quarterly Meeting

Minutes of Meeting

Date
01/12/2016

Present members
Julius Pursaill (Chair)
Colin Taylor
Ewan Smith
Rachel Elwell

In attendance
Ryan Medlock
Piers Hillier
Robert Whitehouse
Ryan Hamill
Niall Aitken
Trevor Greetham
Robert Dundas
Mike Clarkson

Apologies
Isobel Langton
Andy Carter

Owner

1. **REVIEW OF PREVIOUS MINUTES**
The minutes of the 30 August 2016 meeting were approved.

2. **PROJECTS**

RLAM implementation of multi asset transition — PH

An update was provided on the costs involved in the Governed Portfolio strategic asset allocation (SAA) transition which was made in the summer. The decision to transition to the desired tactical asset allocation (TAA), rather than SAA reduced costs by 4 basis points. The cost of the transition to the TAA position came to 6 basis points in total. This includes all frictional costs such as spreads/dilution levies on the underlying funds being bought or sold. The IAC agreed that, based on the information provided, the transition appeared to have been managed in a cost effective manner.

External fund oversight

A paper was presented highlighting the work being conducted to strengthen the oversight of external fund managers in terms of both additional quantitative and qualitative analysis. This has involved collaboration across Royal London to agree a more robust and consistent approach to fund oversight incorporating a new fund screening tool. This paper is also being presented to the Board Investment Committee (BIC). — RE

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To highlight the collaboration undertaken so far, a paper was presented adopting this new approach on one of the external matrix funds currently triggering for review; Neptune European Opportunities. A proposal to replace the fund was debated and approved by the IAC. The IAC noted particular satisfaction with the analysis completed and how this strengthens the overall oversight process. Given the feedback on Neptune, IAC requested that Royal London also review other Neptune fund links. RM

GRIP SAA review

An overview of the GRIP SAA review plan was presented to outline the scope of the work and the risk framework that will be used. Initial results show that the GRIPs continue to perform well, early indications are that some of the changes we made to the SAA in the Governed Portfolios might be beneficial in the GRIPs. The investigations will continue into 2017Q1 and results from the SAA review will be provided at the February IAC meeting. RD

Post Brexit working group meeting and US Election result

An update was provided on a cross-business meeting that was held after the last IAC meeting to consider the impact of Brexit (and other economic headwinds) on economic scenario generator (ESG) modelling. Part of this discussion looked at a challenge that a review of the assumptions underpinning the Governed Portfolios might no longer be appropriate in light of Brexit.

3. CUSTOMER INVESTMENTS

STRATEGIC ANALYSIS

Governed Portfolios & Managed Strategies

No changes are recommended to the Governed Portfolio and Managed Strategy benchmarks this quarter. No SAA changes were made to the Managed Strategies at the point when the positions were changed for the Governed Portfolios in July. Work is ongoing to review this decision.

All of the portfolios remain within their target ranges for real volatility. The real volatility for the majority of the portfolios has remained broadly unchanged compared to the previous quarter. The return efficiency has increased for GP2, Gp9, Cautious Long Strategy and Cautious Medium Strategy bringing them all back on target.

The return efficiency for GP1, GP5 and GP8 have all decreased slightly, and is now outside of the target range. However, the difference is minimal and the IAC remain comfortable.

Governed Retirement Income Portfolios (GRIPs)

There have been no SAA changes for the GRIPs. The long term and short term measure warnings for GRIP5 both have a red warning, suggesting that GRIP5 is not taking enough risk.

Similar to last quarter the long term measure for all the GRIPs is now showing as red. This risk metric compares the portfolios to a 10 year index linked bond, which has seen a further drop this quarter in expected real returns within Moody's model. This suggests that the GRIPs appear to not be taking enough risk. This issue is being addressed through the GRIP SAA review currently ongoing.

Lifestyle Path Analysis

The expected real income for annuity lifestyles has decreased compared to the previous quarter due to a decrease in the yield curve.

The drawdown lifestyles are generating higher expected returns compared to the cash lifestyles, but have lower projected values at the 5% tails, due to the investment in riskier assets.

TACTICAL ANALYSIS

Governed Portfolios & Managed Strategies

All portfolios remain within their tactical risk budgets.

There have been four tactical changes since the last meeting, one in August, September, October and November. The changes in August saw us reducing our exposure to index linked gilts and gilts, whilst increasing our exposure to equities and commodities. The changes in September again saw us reducing our exposure to index linked gilts creating a net underweight position. We used the proceeds to increase our exposure to gilts and corporate bonds and absolute return strategies (including cash).

This leaves the overall position at end September as overweight in equities and corporate bonds, with underweight positions in gilts, index linked gilts, commodities and absolute return strategies (including cash). The portfolios are neutral in property and high yield bonds.

Governed Retirement Income Portfolios (GRIPs)

All portfolios remain within their tactical risk budgets, although GRIP 1 turned amber due to increased stock selection risk. However, we are at the lower end of the amber scale and therefore it was agreed that no action was required at this point.

There have been three tactical changes since the last meeting, one in August, one in September and one in October. The first change was effective as of 11/08/2016 and moved to a more overweight position in equities and an underweight position in index linked gilts.

The second change was effective as of 15/09/2016 and moved to a less underweight position in corporate bonds and a greater underweight position in index linked gilts.

This leaves the overall position at end September as overweight in equities, high yield bonds and gilts. The portfolios are neutral in property and a mixture of overweight and underweight in index linked gilts depending on the portfolio. The portfolios are underweight in corporate bonds.

Short term tactical view of the Chief Investment Officer

PH and TG reviewed Q3 2016 and presented RLAM's rationale for the current short term tactical view:

Positioning

- During the 3rd quarter, portfolios maintained an overweight in equities, with a bias towards overseas markets at the expense of fixed income exposure, concentrated in UK gilts.
- The equity overweight was increased during August at the expense of bonds after stock markets retreated on concerns over a hike in US interest rates despite a dip in US business confidence. This was funded out of fixed income as sovereign bond yields reached all-time lows during the month.
- For portfolios with an allocation to commodities, exposure was moved up to neutral from a small underweight following a supply-driven dip in the oil price which was funded out of cash and absolute return. UK property, which lagged overall portfolio returns, was held at a neutral level during the quarter.

Q3 Market Background

- The dominant themes in Q3 were debate over the impact of Brexit on the global economy and concern over the economic impact of November's tightly contested US presidential election.
- Following an initial setback prompted by the UK's decision to leave the EU, equity markets staged a strong rally with the UK generating the highest regional return on a local currency basis. In Sterling terms, UK equities lagged the global index as currency movements boosted overseas equity returns for sterling based investors.
- In fixed income, bond yields fell to record lows as post-Brexit uncertainty resulted in another round of global monetary easing. Against this backdrop, long dated index linked gilts outperformed all other fixed income segments after further falls in Sterling resulted in a significant rise in UK inflation expectations.
- Sterling weakened against all major currencies, falling by 3% against the US dollar, and 4% against the euro and yen, whilst the US dollar eased after the Fed left rates unchanged.
- Commodities declined over the quarter after the oil price fell back below $50 per barrel, reflecting a lacklustre global economy, before rising sharply towards quarter end on news that OPEC had provisionally agreed to cut oil production to shore up pricing. Industrial and precious metals were marginally higher reflecting a slight weakening of the US dollar.
- UK property returns fell marginally in Q3 after significant volatility in the immediate aftermath of the EU Referendum. During July and August a number of retail property funds closed and instigated substantial sales program to meet redemptions. During September market stability returned and a number of transactions were completed at re-based levels of pricing.

Relative Positioning & TAA Performance

- TAA positioning contributed positively to relative performance over the quarter as portfolios benefited from overweight exposures to outperforming equities, and overseas markets in particular, funded out of fixed interest. UK property, commodity, and cash & absolute return allocations were all maintained at or around benchmark levels.
- Within equities, the preference for overseas markets continued to make a positive contribution as the FTSE World ex-UK Index in GBP outperformed the UK after

Sterling continued to weaken over the quarter. Regionally, overweighting Japan and the Asia Pacific ex-Japan region at the expense of Europe ex-UK also contributed positively to relative return.

- In fixed income, an overweight in investment grade credit, where corporate spreads narrowed, and an underweight in conventional gilts, which lagged overall portfolio returns, both generated positive TAA effects. This was offset by the underweight stance in long-dated index-linked gilts which posted strong returns as UK inflation expectations rose sharply.
- UK property exposure was retained at a broadly neutral level as the market outlook remains delicately poised between post-Brexit uncertainty and the relatively attractive long lease characteristics that makes UK property a relative safe haven asset class for international investors.

Outlook & Views

- The surprise US presidential election result is unlikely to neither derail the recent pick-up in global growth nor result in any significant tightening in monetary policy. As a result, we continue to prefer equities to bonds on relative valuation grounds and our expectation of positive, albeit moderate, global growth. Our preferred regions are Japan and emerging markets.
- We remain underweight bonds and have further reduced our exposure recently, trimming weightings in credit as well as government bonds. We expect global government bond yields to rise from current levels, as the inflation outlook and global growth prospects pick up.
- Although weak during Q3, we retain a broadly neutral stance in commodities with stronger growth in China counter-balanced by a recent strengthening of the US dollar and oversupply.
- We are also neutral on UK commercial property where concerns over a likely slowdown in the economy in 2017 are balanced by our expectations that additional fiscal stimulus will be forthcoming as needed.

6. ROYAL LONDON FUND REVIEW

The following funds/portfolios were discussed:

RLI Governed Range

Eight Governed Portfolios now outperform their benchmark over the three year period up from just two last quarter. In addition, five portfolios are outperforming since launch, up from three last quarter. Only three portfolios are outperforming over 12 months. However, the level of underperformance has improved compared to last quarter. All nine GPs are showing positive stock selection over three years and since launch. Seven GPs are showing positive asset allocation attribution over 12 months.

All of the GRIPs are outperforming benchmark over three years and since launch but only one is outperforming over 12 months. All of the portfolios are showing negative asset allocation attribution over three years and since launch. Only one portfolio is showing positive attribution over 12 months.

RL pension funds

Like many in the market, RLAM were positioned for a ‘remain’ vote in the EU referendum. Within the actively managed equity funds, this meant an above benchmark exposure to UK mid cap which was adversely impacted by the outcome of the referendum. The main source of underperformance has been driven by the market movements over this summer. At the last IAC meeting, RLAM presented a paper detailing the reasons for underperformance. This positioning is still impacting the one year performance figures but the funds outperformed over Q3.

Within the fixed interest funds, RLAM continue to maintain short duration positions on the long-standing belief that yields will rise. Yields have fallen and this has hit performance over the short term.

RLAM funds on watch (fund performance flagged to the IAC):

- **Adventurous Managed**
- **Managed**
- **UK Ethical**
- **UK Mid Cap**
- **European**
- **Worldwide**
- **Global Equity**
- **International Government Bond**
- **Global Index Linked**

Externally managed matrix funds

The following funds are under review and were subject to further action before the meeting:

Fidelity American
At the last IAC meeting, it was requested that we compare the performance of this fund against the other US portfolios that the current fund manager looks after at Fidelity. The manager now has a 12 month track record managing Fidelity American and performance has improved over this time period. The manager has a good track record relative to the peer group since 2013. The two SICAV funds that the manager looks after have comfortably outperformed Fidelity American. A degree of confidence can be taken by this track record but a recommendation was made to the IAC that we closely monitor the performance of this fund and keep ‘under review’.

Schroder Core UK Equity
The fund’s performance has improved over both the long term and the short term. With the exception of Q2, this has been a trend that has developed over 2016. Following the conference call with the manager in June and gaining comfort in their ability to address performance concerns and the uptake in short term performance, a recommendation was made to the IAC to remove from ‘under review’.

Neptune European Opportunities
At the last IAC meeting, the IAC expressed concern with the performance of this fund. The IAC agreed that this fund should be placed ‘under review’ with a view to remove and asked that alternative solutions are investigated.

The fund has largely underperformed since 2012 when it moved to a strong value bias. The manager continues to strongly believe that value opportunities exist within the financials, materials and technology sectors and that we have now reached the end of a value bear market. The manager continues to maintain an overweight position in banks on the belief that they are the deepest value opportunity with the highest dividends.

Morningstar’s level of conviction in the fund has reduced and the Morningstar Rating is now Neutral. Ultimately, the magnitude of the risk taken combined with subsequent underperformance has reduced the fund’s overall appeal in their view.

It was noted that over the last two quarters, the fund has performed much stronger and outperformed its benchmark due to the revival in value stocks. In Q3, the fund outperformed by over 9%.

The IAC recognised this bounce back in short term performance but ultimately approved the decision to replace the fund based on underperformance over the longer term and the magnitude of risk taken within the fund. The analysis completed in this exercise included an additional screening process, a conference call with the fund manager, and annual due diligence as well as the input from Morningstar.

The IAC requested that a suitable replacement for the fund is put forward for approval at the next IAC meeting. RM

The following funds were discussed and will remain on watch and under scrutiny:

Franklin UK Mid Cap
The fund outperformed the benchmark by 1.4% over the third quarter. However, it is still triggering for review due to underperformance over one, three and five years. Longer term performance has marginally improved.

The severity of the second quarter’s underperformance has led to a poor one year track record, with the fund lagging the peer group and benchmark significantly over this period.

Positive sector contributions came from the overweight position in industrial engineering, but having no miners or oil and gas producers was a negative influence.

The fund’s mid-cap bias partly explains the underperformance of the IA All Companies peer group, as mid-caps came under severe pressure following the results of the EU referendum while dollar earning large caps have outperformed. Longer-term returns however remain strong and Morningstar retain our conviction that the fund will outperform in the long term.

Investec UK Smaller Companies
After a painful second quarter, the fund rebounded over Q3 and comfortably outperformed. However, it continues to feel the pain of long-term poor performance.

The fund benefitted from those companies operating overseas. Foreign-currency-earning media companies Next Fifteen Communications and XLMedia performed strongly on the back of the weakening pound, making media the strongest performing subsector. Bid speculation around large holdings Entertainment One and Arrow Global both added to the Fund’s returns.

Continued strength in basic materials and mining, where the fund maintains an underweight position, was the greatest negative contributor to relative performance.

JPMorgan US
The fund marginally outperformed in Q3 but continues to be a poor performer over one, three and five years.

Stock selection in consumer discretionary and financials sectors weighed on performance the most. Within the consumer discretionary sector, an overweight position in Lowe's was the largest detractor. Shares of the stock underperformed during the quarter, driven by poor earnings results versus analyst estimates. Specifically, poor comparable sales performance in the outdoor power equipment, millwork and paint segments, along with adverse weather conditions in Q216 negatively impacted performance. In contrast, stock selection in information technology and consumer staples proved beneficial, with an overweight in Ebay being the largest contributor.

The fund continues to be rated Silver by Morningstar.

Other external funds

There are a few fund groups with a significant number of funds triggering for review. At the last IAC meeting, the IAC expressed concerns about the number of M&G funds underperforming (six in total) and requested further scrutiny on these funds. This quarter, the number of M&G funds triggering has fallen to four which comprises of two equity funds and two fixed interest funds. The two equity funds' performance has improved but the two fixed interest funds' performance has worsened.

The performance of Invesco Perpetual's fixed interest funds is a concern. All four of the fixed interest funds we link to are triggering and performance has worsened over the short-term. We have a meeting scheduled in January with a member of the Inveso Perpetual fixed interest team to discuss the strategies being adopted in these funds and an update will be provided at the next IAC meeting.

Jupiter has the most funds triggering for review with five. The five funds consist of various asset classes and strategies. These funds continue to fare stronger over the longer term relative to the short term which is where the underperformance has struck. A further update on these funds will be provided at the next IAC meeting following a strategy meeting with Jupiter in Q1. RM

The following funds also remain on watch (fund performance flagged to IAC):

- 7IM AAP Moderately Cautious
- Baillie Gifford High Yield Bond
- Baillie Gifford UK Equity
- BMF Balanced
- BMF Defensive Income
- Fidelity Emerging Europe, Middle East and Africa
- Fidelity Strategic Bond
- Fidelity UK Select
- GLG Balanced Managed
- GLG Stockmarket Managed
- Invesco Perpetual Corporate Bond
- Invesco Perpetual Distribution
- Invesco Perpetual Global Bond

- Invesco Perpetual Monthly Income Plus
- Investec Emerging Local Currency Debt
- Investec Global Energy
- Investec UK Special Situations
- JPMorgan Cautious Managed
- JPMorgan Natural Resources
- Jupiter Ecology
- Jupiter European Special Situations
- Jupiter Financial Opportunities
- Jupiter Merlin Income
- Jupiter Merlin Worldwide
- Legg Mason US Smaller Companies
- M&G Global Basics
- M&G Optimal Income
- M&G Recovery
- M&G Strategic Corporate Bond
- Neptune Balanced
- Neptune Global Alpha
- Neptune Global Equity
- Neptune US Opportunities
- Schroder European Opportunities
- Schroder MM Diversity Tactical
- Schroder MM UK Growth
- Schroder Global Cities Real Estate
- Schroder Income Maximiser
- Columbia Threadneedle Absolute Return Bond
- Columbia Threadneedle Latin America
- UBS Global Blended (50:50)

7. **AOB**

In response to a query about socially responsible investment (SRI) integration into the investment process and noting the Pension Regulator's increasing interest in SRI risk management, the IAC asked a member of RLAM's sustainable investment team to update the committee on their progress. PH

8. **DATE FOR NEXT MEETING**

The next quarterly meeting is 28 February 2017.

IMPORTANT INFORMATION

Past performance is not a guide to the future. Prices can go down as well as up. Investment returns may fluctuate and are not guaranteed so you could get back less than the amount paid in.

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